

PRIVATE RULING 9546018

3121.04-00

DATE: August 18, 1995

Refer Reply to: CC:EBEO:2

LEGEND:

Company A = \* \* \*

Covered Employees = \* \* \*

X = \* \* \*

Year O = \* \* \*

Year P = \* \* \*

Year Q = \* \* \*

Year R = \* \* \*

Year S = \* \* \*

Year V = \* \* \*

Year W = \* \* \*

Year X = \* \* \*

Year Y = \* \* \*

Year Z = \* \* \*

Date M = \* \* \*

Dear \* \* \*

This is in response to your letter on behalf of Company A. Your letter requests a ruling that (1) Company A may bring itself into compliance with sections 6041 and 6051 of the Internal Revenue Code and (2) Company A may take measures in Year Z to ensure that certain of its qualified plans continue to qualify under section 401(a) pursuant to the facts described below.

In Year P, the Internal Revenue Service audited Company A and classified individuals performing certain services as employees ("Covered Employees"). Since Year P, Company A has treated these workers as employees for purposes of the Federal Insurance Contribution Act (FICA), Federal Unemployment Tax Act (FUTA), and Collection of Income Tax at Source on Wages. In addition, Company A has reported the income paid to Covered Employees as wages on Form W-2. Company A also has allowed Covered Employees to participate in certain tax-qualified retirement plans and other employee benefit programs.

Individual X has performed services for Company A as a Covered Employee since Year O. As is the case with all Covered Employees, X has been treated as an employee for purposes of income and employment taxes and participation in Company A's qualified retirement and other employee benefit programs. It is Company A's understanding that, prior to X's awareness of certain changes made by the Tax Reform Act of 1986, X did not object to or attempt to have Company A change his status as an employee.

X participated in Company A's 401(k) plan and defined benefit plan (the "Plans"). Company A's 401(k) plan prohibits any of the funds or the income thereon resulting from contributions to the plan from being used or diverted to purposes other than the exclusive benefit of participants and their beneficiaries. The 401(k) plan defines participant as any present or former employee who has completed certain requirements. Company A's defined benefit plan contains similar restrictions on the use of the plan's funds and participation. The Plans also provide that the Plan Administrator shall when possible make adjustments to payments that, in his or her sole judgment, would result in a participant receiving the proper amount of payments under the plan.

The Key District Director issued determination letters that Company A's Plans and their corresponding trusts qualified under sections 401(a) and 501(a) of the Code. Company A intended at all times to operate these plans for the exclusive benefit of its employees and their beneficiaries. Company A made contributions on X's behalf to these Plans. In addition, X made elective contributions to the 401(k) plan.

X was also eligible to participate in other Company A employee benefit programs. These benefit programs included the following: (1) group health insurance intended to be governed by sections 105 and 106 of the Code; (2) group term life insurance intended to qualify under section 79; and (3) flexible spending benefits, offered under Company A's cafeteria plan intended to qualify under section 125.

Despite being treated by Company A as an employee and receiving a Form W-2, X took the position on his Year R and Year S federal income tax returns that he rendered services to Company A as an independent contractor for purposes of deducting his unreimbursed business expenses. X included the amount reported by Company A as wages. However, X claimed his business deductions relating to his performance of services as a Covered Employee on Schedule C rather than Schedule A. X did not file a Schedule SE with his Year R and Year S returns and did not pay any self-employment tax.

The Internal Revenue Service disagreed with X's claim that he was an independent contractor and issued X a statutory notice of deficiency. The Service's position was that X was an employee and that his business expenses were allowable only as Schedule A unreimbursed employee business expenses, deductible only to the extent that the aggregate of these deductions exceeded 2 percent of X's adjusted gross income. See section 67(b) of the Code. In addition, the Service contended that X was subject to the alternative minimum tax for Year S. See section 56(b).

X challenged the Service's assessment in the U.S. Tax Court. In Year Z (on Date M) after examining all the relevant facts and circumstances and claiming to apply the common law principles, the U.S. Tax Court ruled that X was performing services for Company A as an independent contractor during the years in question.

RULING REQUEST #1

Company A requests a ruling that it may bring itself into compliance with sections 6041 and 6051 of the Code by doing the following:

- A. Issuing corrected Forms W-2 with respect to X for Year R through Year Y. These corrected Forms W-2 will report taxable wages of \$0 for Year R through Year Y.
- B. Issuing corrected Forms 1099 to X for Year R through Year Y. Each Form 1099 will report self-employment income for each respective tax year in an amount equal to the sum of (i) the amount that was reported as wages on the original Form W-2 for X for that year, (ii) the value of any health and medical care benefits and group term life insurance provided to X by Company A, (iii) the value of benefits made available to X under Company A's cafeteria plan, computed in the manner specified in section 1.125-1, Q&A 11 of the Proposed Income Tax Regulations, and (iv) if required pursuant to ruling request number 2, X's elective contributions to the 401(k) plan and earnings thereon.

#### APPLICABLE LAW

Section 3102 of the Code requires employers to withhold the FICA tax imposed on an individual employee by section 3101 from wages as and when paid. In general, section 3121(a) defines the term "wages" as all remuneration for employment.

Section 3402 of the Code requires employers, except as otherwise provided, to deduct and withhold federal income tax upon the payment of wages. In general, section 3121(a) defines "wages" as all remuneration for services performed by an employee for his employer.

Section 3301 of the Code imposes on every employer the FUTA tax on total wages paid by an employer during each calendar year.

Section 6041 of the Code requires all persons engaged in a trade or business to make an information return for payments of \$600 or more made to another person in the course of the trade or business. Section 1.6401-1(a)(2) of the Income Tax Regulations provides, in part, that the return required under section 6041 shall be made on Forms 1096 and 1099 except that the return with respect to certain payments of compensation to an employee by his employer shall be made on Form W-2 and W-3. Section 1.6041-2(a)(1) provides that wages, as defined in section 3401, paid to an employee are required to be reported on Form W-2.

Section 6041(d) of the Code provides that every person required to make a return under section 6041(a) shall furnish to each person with respect to whom such a return is required a written statement showing (1) the name and address of the person required to make such return, and (2) the aggregate amount of payments to the person required to be shown on the return.

Section 6051(a) of the Code requires, in part, that an employer

shall provide its employees a written statement showing (1) the total amount of wages as defined in section 3401; (2) the total amount deducted and withheld as tax under 3402; (3) the total amount of wages as defined in section 3121(a); and (4) the total amount deducted and withheld as tax under section 3101.

Section 61(a)(1) of the Code provides that, except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Generally, the cost of life insurance protection under a life insurance contract provided to an employee or independent contractor in connection with the performance of services is includible in gross income. The cost of such protection is the reasonable net premium cost, as determined by the Commissioner. See section 1.83-1(a)(2) of the regulations. (The Commissioner has ruled that the cost to be included is the "P.S. 58 rate" or, if lower, initial issue rates published by the insurer applicable to all standard risks. See Rev. Rul. 64-328, 1964-2 C.B. 11, amplified by Rev. Rul. 66-110, 1966-2 C.B. 105.) Special rules, however apply to group-term life insurance provided to an employee.

Section 79 of the Code generally allows an exclusion from gross income for the cost of up to \$50,000 of group-term life insurance coverage provided to an employee by an employer. The remaining cost of the insurance (less any amount paid by the employee for the insurance) is included in the employee's income. Section 79(e) of the Code provides that the term "employee" includes a former employee.  
/1/

Section 106 of the Code provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1 of the regulations provides that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident or health benefits directly or through insurance to one or more of his employees.

Rev. Rul. 56-400, 1956-2 C.B. 116, provides that the exclusion from gross income provided under section 106 of the Code does not apply to premiums paid for an individual who is not an employee either under the common law concept or as defined in section 7701(a)(20) of the Code. Thus, the ruling holds that the insurance premiums paid on behalf of such an individual and his beneficiaries are includible in his gross income for federal income tax purposes.

Section 125(a) of the Code provides that no amount shall be

included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Cafeteria plans may offer employees choices among cash and "qualified benefits" that are excludable from gross income and wages under a specific Code section.

Section 125(d) of the Code defines the term "cafeteria plan" as a written plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits. Section 1.125-1 Q&A-4 of the proposed regulations provides that the term "employee" includes present and former employees of the employer. Even though former employees generally are treated as employees, a cafeteria plan may not be established predominately for the benefit of former employees.

## CONCLUSION

Under the facts described above and prior to the Tax Court's decision on Date M, Company A appropriately filed Forms W-2 for X for Year R through Year Y and furnished copies to X. Nonetheless, Company A may file Forms W-2 with respect to X with taxable income in the amount of \$0 for Year R through Year Y to reflect the Tax Court's decision that X was an independent contractor and not an employee. Company A should provide copies of these Forms W-2 to X.

As a further consequence of the Tax Court's decision, X may no longer receive favorable tax treatment in connection with Company A's employee benefit programs. Thus, it is also appropriate for Company A to file Forms 1099 under section 6041 of the Code with respect to X for Year R through Year Y with self-employment income in an amount equal to the sum of the following: (1) the amount that was reported as wages on the original Form W-2 for X for that year; (2) the value of any health and medical care benefits and group term life insurance provided to X by Company A; and (3) the value of benefits made available to X under Company A's cafeteria plan, computed in the manner specified in section 1.125-1, Q&A 11 of the proposed regulations for each such year. /2/ Company A should furnish copies of these Forms 1099 to X. Company A's reporting requirements of X's benefits under Company A's qualified plans are discussed below.

## RULING REQUEST #2

Company A requests a ruling whether it would be consistent with the requirements for qualification under section 401(a) of the Code for X to continue to participate in and accrue benefits under Company A's 401(k) plan and defined benefit plan.

## APPLICABLE LAW

Sections 401(a)(2) of the Code and 404(a)(1)(i) of the Employee Retirement Income Security Act of 1974 (ERISA) provide that a plan can be a qualified plan, and a trust related to a plan can be a qualified trust, only if the assets of the trust must be used for "the exclusive benefit of the employer's employees or their beneficiaries." /3/ A plan that covers an individual based on his or her service as an independent contractor rather than as an employee

would violate the exclusive benefit rule.

Section 1.401-1(b)(3) of the regulations provides that the law concerning plan qualification is concerned not only with the form of a plan but also with its effects in operation. Thus, a plan must comply with the exclusive benefit rule in operation as well as in form.

The standard used to determine whether a worker is an employee for ERISA and section 401(a)(2) of the Code is the same common law standard applied under section 3121(d) of the Code. See, *Darden v. Nationwide Mutual Insurance*, 503 U.S. 318 (1992) and also *Professional & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 235 (1987), *aff'd* 862 F. 2d 751 (9th Cir. 1988), which held that a taxpayer's pension and profit sharing plans did not meet the "exclusive benefit" rule under section 401(a) because the plan benefited workers who were not common law employees.

## CONCLUSION

The Tax Court on Date M held that X was not an employee of Company A for Year R and Year S based on the common law standard. Thus, Company A would not be acting in a manner consistent with the requirements for qualification under section 401(a) of the Code if it allowed X, an independent contractor, to continue to participate in and accrue benefits under its 401(k) plan and defined benefit plan.

## RULING REQUEST #3

If X's participation in the Plans is not consistent with the qualification requirements under section 401(a) of the Code, Company A requests the following ruling:

A. Company A's Plans and their corresponding trusts will not be disqualified under section 401(a) and 501(a) of the Code for including X as an active participant for tax years after Year Q provided that the corrective measures specified below are taken to ensure that the Plans are maintained for the exclusive benefit of common law and eligible statutory employees; and

B. The following corrective measures to rescind X's treatment as an active participant in the Plans for tax years after Year Q will not disqualify the Plans and their corresponding trusts under sections 401(a) and 501(a) of the Code:

i. With respect to the 401(k) plan, all of X's elective, contributions for tax years since Year Q, and actual earnings thereon, will be refunded to him in Year Z and either (1) included on the corrected Form 1099 for the respective year for which the elective contribution was made, or (2) reported by the Plan Administrator of the 401(k) plan on Form 1099-R as a "nonqualified" distribution from the plan.

ii. With respect to the defined benefit plan, any accruals

recorded for or reported to X for tax years since Year Q will be cancelled. No amounts in the trust fund will be returned to Company A. X's benefits accrued for service prior to Year R will not be affected.

## APPLICABLE LAW

Section 402(a) of the Code provides, in part, that any amount actually distributed to any distributee by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributees under section 72 in the taxable year of the distributees in which distributed.

Section 402(b)(1) of the Code provides, in part, that contributions to an employees' trust made by an employer to a trust that is not exempt from tax under section 501(a) shall be included in the gross income of the employee in accordance with section 83.

Section 83 of the Code provides that property transferred in connection with the performance of services shall be included in gross income of the person who performed the services in the first taxable year in which the rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. Section 1.83-3(e) of the regulations provides, in part, that for purposes of section 83 the term "property" includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.

An established principle under case law is that taxpayers owe the government a "duty of consistency." See *Beltzer v. U.S.*, 495 F.2d 211 (8th Cir. 1974). /4/ This duty requires a taxpayer to treat an item of income for the year in question consistently with his or her prior erroneous treatment of the same item, where correction of the earlier erroneous year is barred by the statute of limitations. See *Orange Securities Corporation v. Commissioner*, 131 F.2d 662, 663 (5th Cir. 1942).

## CONCLUSION

X participated in Company A's Plans that were intended to be qualified plans. Company A and the Plans' Administrators believed X was an employee and, therefore, eligible to participate in the Plans. Moreover, neither Company A nor the Plans' Administrators was a party to the Tax Court's decision on Date M. Accordingly, for years after Year Q the Plans should not be disqualified on account of X's participation, provided corrective measures are taken.

With regard to Company A's defined benefit plan, Company A may retroactively cancel X's participation in the defined benefit plan for tax years since Year Q. In accordance with the terms of the plan, Company A may issue corrected benefit statements showing that no additional benefits accrued to X after the Year Q plan year. X's accrued benefits through the Year O plan year may remain intact.

With regard to Company A's 401(k) plan, Company A may

retroactively cancel X's participation in the 401(k) plan for tax years since Year Q. Company A may also refund and distribute in Year Z all of X's elective contributions and the actual earnings thereon for tax years since Year O.

Prior to the Tax Court decision on Date M, X was treated as a qualified participant in Company A's 401(k) plan. The contributions made to the 401(k) plan on X's behalf and any earnings attributable to such contributions prior to Year Z were presumably not included in X's gross income. Since the distribution by Company A of X's elective contributions and the earnings thereon occur in Year Z, Company A should not report these amounts on the corrected Forms 1099 issued to X for Year R through Year Y. Rather, X's elective contributions and the earnings thereon distributed in Year Z by Company A should be reported to X in the following manner. First, the portion of the distribution attributable to amounts contributed in Year W, Year X, and Year Y, and any plan earnings during such years, are includible in X's gross income under section 83 of the Code and, therefore, the amounts must be reported on the corrected Forms 1099 issued to X for Year W, Year X, and Year Y. Second, the portion of the distribution attributable to the elective contributions and earnings thereon from Year R through Year V are includible in X's gross income in Year Z under sections 61 and 72 and the "duty of consistency doctrine," and, therefore, must be reported on a Form 1099-R in Year Z. The application of the duty of consistency doctrine in this case requires that the 401(k) plan be treated as a qualified plan and qualified cash or deferred arrangement for Year R through Year V.

No opinion is expressed on the tax consequences of the above transaction under any other section of the Code. This ruling is directed to the taxpayer that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

JERRY E. HOLMES  
Chief, Branch 2  
Office of the Associate  
Chief Counsel  
(Employee Benefits and  
Exempt Organizations)

Enclosure

Copy for section 6110 purposes

#### FOOTNOTES

/1/ Section 1.79-0 of the regulations provides that a person who formerly performed services as an employee and currently performs services for the same employer as an independent contractor is an employee only with respect to insurance provided because of the person's former services as an employee.

/2/ If X's status prior to Year R was that of an employee, then the exclusion under sections 79 and 125 may still be allowable, but only if Company A allowed X to participate because of X's former

services with Company A. It is more likely, however, that Company A provided X group term life insurance and allowed X to participate in the cafeteria plan because of the services X was providing at the time.

/3/ Section 7701(a)(20) of the Code provides that for certain purposes, including qualified plans, a full-time life insurance salesman is treated as an employee, if he or she is considered an employee for purposes of the Federal Insurance Contributions Act ("FICA"). This provision does not apply to X.

/4/ The court in Beltzer set forth the following three elements of the duty of consistency: (1) the taxpayer has made a representation or reported an item of income for tax purposes in one year; (2) the Commissioner has acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessment bars adjustment for the initial year.

In *Grayson v. United States*, 437 F. Supp. 58 (N.D. Ala. 1977), the taxpayer received distributions from a nonqualified pension plan in 1971. The taxpayer asserted that the distributions were not includible in gross income in 1971 because the amounts attributable to the distributions were includible in earlier closed years pursuant to section 402(b) of the Code and the doctrine of constructive receipt and economic benefit. The District Court rejected this assertion on two grounds. First, the court held that, under the terms of the plan, the amounts were not nonforfeitable during the earlier closed years. Second, the court held that, even assuming the amounts were nonforfeitable and thus includible in the taxpayer's gross income during the closed years, based on the duty of consistency doctrine, the amounts were taxable at the time of the distribution in 1971.

END OF FOOTNOTES